09-2689
AUDIT
SIGNED 10-05-2010

BEFORE THE UTAH STATE TAX COMMISSION

PETITIONER, Petitioner, v. AUDITING DIVISION OF THE UTAH STATE TAX COMMISSION, Respondent.	**INITIAL HEARING ORDER** Appeal No. 09-2689 Account No. ##### Tax Type: Income Audit Period: 2006 Judge: Phan

Presiding:
Jane Phan, Administrative Law Judge

Appearances:
For Petitioner: PETITIONER REP., Representative
For Respondent: RESPONDENT REP. 1, Assistant Attorney General
RESPONDENT REP. 2, Manager, Income Tax Auditing
RESPONDENT REP. 3, Senior Auditor

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission for an Initial Hearing pursuant to Utah Code Sec. 59-1-502.5 on June 21, 2010. Petitioner (the Taxpayer) is appealing an audit deficiency issued by Respondent (the Division) for the 2006 tax year in which the Division denied an enterprise zone credit claimed on the individual income tax return filed by the Taxpayer. The original Statutory Notice of Deficiency and Audit Change for the 2006 tax year had been mailed on April 14, 2009. The amount of additional tax due from the original audit had been $$$$$ plus interest. After this audit had been issued the Taxpayer provided additional information and the Division then allowed a portion of the credit claimed in the amount of $$$$$. Based on this change the Audit was amended on July 21, 2009, to a tax deficiency of $$$$$ plus interest, which at that time had been $$$$$ and continues to accrue. The Taxpayer timely appealed the amended audit for the 2006 tax year.

APPLICABLE LAW

Enterprise Zone Credits are provided at Utah Code 62-38f-413(1) (2006)[1] as follows:

> Subject to the limitations of Subsections (2) through (4), the following nonrefundable tax credits against a tax under Title 59, Chapter 7, Corporate Franchise and Income Taxes, or Title 59, Chapter 10 Individual Income Tax Act, are applicable in an enterprise zone: . . . (g) an annual investment tax credit of 10% of the first $250,000 in investment, and 5% of the next $1,000,000 qualify investment in plant, equipment, or other depreciable property.

A further qualification for the credit is located at Utah Code Ann. §63-38f-412 (2006) which provides that to qualify for an enterprise zone credit, a business must meet residency requirements as follows:

> The tax incentives described in this part are available only to a business entity for which at least 51% of the employees employed at facilities of the business entity located in the enterprise zone are individuals who, at the time of employment, reside in the county in which the enterprise zone is located.

"Business entity" is defined at Utah Code Sec. 63-38f-402 as follows:

> "Business entity" means an entity: (a) including a claimant, estate, or trust; and (b) under which business is conducted or transacted.

Employee is specifically defined at Utah Admin. Rule R865-9I-37 (2006) as follows:

> A. Definitions: . . . 3. "Employee" means a person who qualifies as an employee under Internal Revenue Service Regulation 26 CFR 31.3401(c)(1).
> . . .
> D. To determine whether at least 51 percent of the business firm's employees reside in the county in which the enterprise zone is located, the business firm shall consider every employee reported to the Department of Workforce Services for the tax year for which an enterprise zone credit is sought.

Internal Revenue Service Regulation 26 CFR 31.3401(c)(1)(2006) provides that a partner or officer of a corporation could be an employee if the relationship of employer and employee exists. This Regulation provides in pertinent part:

> (a) The term employee includes every individual performing services if the relationship between him and the person for whom he performs such services is the legal relationship of employer and employee . . .
> (b) Generally the relationship of employer and employee exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished.
> . . .

1 This is a revision from the prior year. This decision will refer to the provisions in effect for the 2006 tax year unless otherwise noted.

> (e) If the relationship of employer and employee exists, the designation or description of the relationship by the parties as anything other than that of employer and employee is immaterial. Thus, if such relationship exits, it is of no consequence that the employee is designated as a partner, co adventurer, agent, independent contractor, or the like.
> . . .
> (f) All classes or grades of employees are included within the relationship of employer and employee. Thus, superintendents, managers and other supervisory personnel are employees. Generally, an officer of a corporation is an employee of the corporation. However, an officer of a corporation who as such does not perform any services or performs only minor services and who neither receives nor is entitled to receive directly or indirectly, any remuneration is not considered to be an employee of the corporation. A director of a corporation in his capacity as such is not an employee of the corporation.
> (g) The term employee includes every individual who receives a supplemental unemployment compensation benefit which is treated under paragraph (b)(14) of Sec. 31.3401(a)-1 as if it were wages.
> (h)Although an individual may be an employee under this section, his services may be of such a nature, or performed under such circumstances, that the remuneration paid for such services does not constitute wages within the meaning of section 3401(a).

The burden of proof in on the Petitioner in these proceedings pursuant to Utah Code Sec. 59-1-1417 (2009) which provides:

> In a proceeding before the commission, the burden of proof is on the petitioner . . .

Generally, tax exemption or tax credit statutes are strictly construed against the taxpayer. *See Parson Asphalt Prods., Inc. v. State Tax Comm'n*, 617 P.2d 397, 398 (Utah 1980)("[s]tatutes which provide for exemptions should be strictly construed, and one who so claims has the burden of showing his entitlement to the exemption"). Tax credit statutes, like tax exemptions, "are to be strictly construed against the taxpayer." *MacFarlane v. State Tax Comm'n*, 2006 UT 18, ¶11. "While we recognize the general rule that statutes granting credits must be strictly construed against the taxpayer, the construction must not defeat the purposes of the statute. The best evidence of that intent is the plain language of the statute." (Citations omitted.) *See id. at* ¶19.

DISCUSSION

From the information submitted by the representative for the Taxpayer the enterprise zone credit at issue in the amount of $$$$$ was based on the FAMILY PARTNERSHIP's ("Family Partnership's") purchase of a AIRCRAFT and a VEHICLE. The Taxpayer in this matter, PETITIONER held a 12% partnership interest in the Family Partnership and the portion of the enterprise zone credit claimed by the Family Partnership that passed through to his individual income tax return was the $$$$$ at issue in this appeal. At the hearing the Division stated the reason it denied the credit was its determination that the Family

Partnership had no employees. It was the Division's position, under Utah Code Sec. 63-38f-412, in order to qualify for the credit the business must have employees. The Division acknowledged if the employee requirement was met the partnership would qualify for the enterprise zone credit. The Division did not challenge that the entity at issue, Family Partnership, was an business entity pursuant to Utah Code Sec. 63-38f-402(1) nor did it dispute that Family Partnership had facilities located in the enterprise zone as required by Utah Code Sec. 63-38f-412.[2] Therefore, these requirements were not addressed by the parties at the hearing and for purposes of this decision it is assumed they were met.[3]

It was the representative for the Taxpayer's position that PERSON, who had a 1% partnership interest and was the general partner and managing partner of the Family Partnership, should be considered an employee. There was no dispute that PERSON resided in the county in which the enterprise zone was located. There was no other person who could have been considered to be an employee of the Family Partnership. The Taxpayer's representative provided little information about the business of the Family Partnership or the tasks that PERSON performed other than she was apparently the person who saw that returns were filed and other paperwork as needed. The representative proffered that PERSON had received remuneration for this service which she had claimed as self employment income on her return. The amount she had received was not provided. Further, the Taxpayer's representative acknowledged that PERSON was not required to be reported as an employee to the Department of Workforce Services. The Taxpayer's representative pointed to the definition of employee at Internal Revenue Service Regulation 26 CFR 31.3401(c)(1)(2006) which indicated that an officer or partner could be an employee. The Regulation further indicated that a person could be an employee regardless of whether the remuneration received for the services constituted wages. It was the Taxpayer's position that a person could be an employee under Internal Revenue Service Regulation 26 CFR 31.3401(c)(1)(2006) but also be exempt from having to file as an employee for purposes of the Department or Workforce Services. The Division did not refute this point, but did not find it supportive of allowing the credit.

It was the Division's position that PERSON's was not an employee and since the Family Partnership

2 Nor did the Division dispute that the depreciable property for which the credit was claimed met the additional requirements provided at Utah Admin. Rule R865-9I-37 (B) (2006).

3 Should the matter proceed to a Formal Hearing, unless the Division formally stipulates to these other requirements, the Taxpayer, should be prepared to establish through testimony and evidence that all requirements under the Enterprise Zone Act and Utah Admin. Rule R865-9I-37 (2006) were met including, and in addition to the employee requirement, that the Family Partnership conducted or transacted business, had a facility in the enterprise zone at which the employee was employed and the depreciable property acquired is in a business operated within the enterprise zone. See Utah Code Sec. 63-38f-401 (2006) et al. and Utah Admin. Rule R865-9I-37 (2006).

had no employees its purchases of the aircraft and vehicle did not qualify for the enterprise zone credit. The Division pointed out that one of the requirements for the credit was set out at Utah Code Sec 63-38f-413 and that section required the entity claiming the credit have employees.[4] That provision states the credits "[a]re available only to a business entity for which at least 51% of the employees employed at facilities of the business entity located in the enterprise zone are individuals who, at the time of employment reside in the county in which the enterprise zone is located." The Division pointed out that PERSON was not an employee reported to the Department of Workforce Service and, therefore, under Utah Admin. Rule R865-0I-37(D) would not be counted toward the 51% requirement.

The Division also relies on Private Letter Ruling 99-021, issued by the Commission on October 17, 2000, in which the question of whether a partner could be an employee for purposes of the enterprise zone credit was directly addressed. In that Ruling the Commission found, "[a] qualifying sole proprietorship which has employees would be eligible for enterprise zone tax credits, while a sole proprietorship without employees would not. Similarly, a partnership without employees, where the partners receive payments that are subject to self employment tax at the individual level, would not be eligible for the tax credits."

The Division explained that the reason it had amended its audit and allowed $$$$$ in credit was that another entity, COMPANY, had employees and qualified for credits on items which that entity had purchased. COMPANY also was a pass through entity to the Family Partnership which in turn passed the credits through to the Taxpayer. There was no indication that both COMPANY and the Family Partnership were operating a combined business.[5]

Upon review of the evidence and information presented by the parties at the hearing the Division properly disallowed the enterprise zone credit for items purchased by Family Partnership. Generally tax credit statutes are strictly construed against the taxpayer. *See Parson Asphalt Prods., Inc. v. State Tax Comm'n,* 617 P.2d 397, 398 (Utah 1980); and *MacFarlane v. State Tax Comm'n*, 2006 UT 18. In this matter it is clear upon review of the statute that the intent of the legislature was that the credit be provided to business entities that conducted or transacted business and had employees working in a facility of the business located in the

4 That there must be employees employed at facilities of the entity located in the enterprise zone to qualify for the credit is consistent with the Tax Commission's previous decisions in Appeal Nos. 06-1024 and 08-1928.

5 After the Initial Hearing in this matter the Commission issued on August 1, 2010, a decision in Appeal No. 08-1928, in which the Commission concluded that several pass through entities that were working together as one business could qualify for the credit regardless of the fact that the entity that purchased the equipment was not the same entity that had employees. Appeal No. 08-1928 was based on the prior statute which had been amended for the 2006 tax year. There was no information presented that would indicate the facts in this case were similar to those in Appeal 08-1928.

enterprise zone. See Utah Code Sec. 63-38f-402. Further, the statutory provisions require that at least 51% of the employees resided in the county in which the zone was located. See 63-38f-412. The Tax Commission Rule defines employee at Utah Admin. Rule R865-9I-37(A)(3) (2006) as a person who qualifies as an employee under 26 CFR 31.3401(c)(1). Then the rule further clarifies that for purposes of determining the 51% of employees, every employee reported to the Department of Workforce Services for the tax year should be considered. See Utah Admin. Rule R865-91-37(D).

The Division points to the Tax Commission's Advisory Opinion 99-021 as support for its position that PERSON was not an employee for purposes of determining eligibility for the credit. The Commission should take note that what the opinion had stated was "a partnership without employees" would not qualify. In this matter the Taxpayer argues that the Family Partnership had an employee. As noted by the representative for the Taxpayer, Utah Admin. Rule R865-9I-37(A)(3)'s definition of "employee" is not necessarily consistent with someone who is reported as an employee to the Department of Workforce Services. Upon review of the interrelationship between Subsection (D) and the definition of "employee" at Subsection (A) of that rule, the provision to consider employees reported to Workforce Services does not necessarily exclude persons who would otherwise qualify as an employee under R865-9I-37(A)(3) but instead requires all employees who are reported to Workforce Services to be counted. Therefore, if PERSON qualified as an employee under 31.3401(c)(1), she could be considered in the count toward the 51% requirement. Further, the Division did not assert that the business would need more than one employee to qualify for the credit.

However, the Taxpayer in this matter has failed to provide the factual information necessary to show that PERSON would, in fact, have been considered an employee under Regulation 31.3401(c)(1). The Regulation provides a number of considerations and the Taxpayer failed to provide evidence of the relationship between PERSON and the employer. The Taxpayer has the burden of proof in this proceeding under Utah Code Sec. 59-1-1401 and has failed to demonstrate the factors provided in that Regulation that would establish the relationship of employee/employer. Therefore the credit was properly denied by the Division.

Jane Phan
Administrative Law Judge

ORDER

On the basis of the foregoing, the Commission sustains the audit deficiency issued by the Division for the 2006 tax year. It is so ordered.

This decision does not limit a party's right to a Formal Hearing. However, this Decision and Order will become the Final Decision and Order of the Commission unless any party to this case files a written request within thirty (30) days of the date of this decision to proceed to a Formal Hearing. Such a request shall be mailed to the address listed below and must include the Petitioner's name, address, and appeal number:

Utah State Tax Commission
Appeals Division
210 North 1950 West
Salt Lake City, Utah 84134

Failure to request a Formal Hearing will preclude any further appeal rights in this matter.

DATED this _____ day of _____, 2010.

R. Bruce Johnson
Commission Chair

Marc B. Johnson
Commissioner

D'Arcy Dixon Pignanelli
Commissioner

Michael J. Cragun
Commissioner

Notice: If a Formal Hearing is not requested as discussed above, failure to pay the balance resulting from this order within thirty (30) days from the date of this order may result in a late payment penalty.

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